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The length and severity of depressions depend partly on the magnitude of the “real” maladjustments which developed during the preceding boom and partly on aggravating monetary and credit conditions — a scramble for liquidity by financial institutions, as well as by others, destruction of bank money by bank failures... Monetary and financial complications during the depressions are partly the consequence of monetary forces during the preceding expansion.

— Gottfried Haberler, *Prosperity and Depression*, 1937

## A RUDE AWAKENING AHEAD

Pundits worldwide are pondering what is irking the American investor. Is he scared of rising inflation and interest rates? Or is he scared of Fed overkill and weaker economic growth?

We have no idea what people in general are thinking or expecting. But what we have been reading until quite recently suggests to us the complete absence of any serious concern about the U.S. economy. Forecasts even from the international organizations envision economic growth above 3% as far as the eye can see. Some admit the probability of a little slowing in the second quarter, but after that, it is off to the races again. There is no talk even of a soft landing, because nobody sees any serious slowdown of the economy in the first place.

Economic data are, admittedly, mixed. So they certainly appear to most people. Not to us, though. Recent data have shown a sharp slowdown in economic activity in conjunction with continued acceleration in inflation. For the CPI, the annual inflation rate reported for May surged to 4.2%, from 3.6% in April. Focusing on the most important aggregates, we observe a distinct downshift in economic growth now in its third or fourth month, and accelerating.

Manifestly, these most important components are consumer spending, employment, income growth, residential building and asset prices.

In the last letter, we expressed the view that a recession and a bear market in asset prices are inevitable for the U.S. economy. It goes without saying that this will have very serious consequences for the rest of the world. Recent economic data leave no doubt that both are on their way. What keeps triggering rebounds in U.S. stocks is only the “bad news is good news” syndrome, reflecting the hope that economic weakness will stop the Fed’s rate hikes.

During the last three months, March–May, for which full data are available, consumer spending has risen 0.3% (1.2% annualized). Reported retail sales for June are down 0.1% before inflation adjustment. Year over year, they increased 5.7% before and 1.4% after inflation.

Nonfarm payrolls grew in the second quarter by 108,000 per month, well off the first quarter’s 176,000. It was the slowest quarter since Q3 2003, when the economy finally pulled out of the jobless recovery. The private sector added only 86,000 new jobs during the quarter.

Residential building contributed 0.38 percentage points to real GDP growth during the last two quarters (Q4 2005–Q1 2006). This compares with 1.18 percentage points in the first half of 2005. Consider that building has the highest multiplier effects, generating jobs and additional spending. Retail trade and residential building together account for 75% of GDP.

It is no secret what has mainly pulled the U.S. economy out of its 2001 recession. The Greenspan Fed succeeded in offsetting the depressive impact of plunging stock prices and business investment on the economy by inflating house prices, which lubricated an unprecedented consumer borrowing-and-spending binge. For the first time in history, a central bank systematically engineered an asset and credit bubble for the explicit purpose

of precipitating economic growth.

“Asset-driven” economic growth became the new conventional label for this new pattern of growth. Policymakers and quite a few others have apparently come to appreciate it as a valid alternative to the traditional income-driven economic growth. It is not. It is the road into the next asset bust.

Appearances of a few years are deceptive. Asset-driven economic growth is a badly flawed and dangerous alternative for two reasons: *First*, asset prices cannot rise in perpetuity; and *second*, it involves exorbitant credit and debt growth, lured by the rising asset prices and excessively optimistic expectations.

Growth by way of the old-fashioned business cycle never ended, because it was self-sustaining. Bubble-driven growth invariably ends when asset prices stop rising. In the U.S. case of the late 1920s and Japan’s case of the late 1980s, asset prices collapsed, with huge damage to the balance sheets of banks, firms and private households.

## **WEALTH DELUSION**

Of course, the sudden fabulous “wealth creation” in particular kindles the readiness to stampede into debt. In the United States, debts of private households since 2000 have soared from \$6,966.7 billion to \$11,840.1 billion (Q1 2006). This represents an increase by \$4,873.4 billion, or 70%. But this record debt growth is discarded as irrelevant because the net worth of private households — asset values minus outstanding debt — over the same time has surged from \$42,113.5 billion to \$53,830.3 billion. In other words, asset values have risen much faster than debts.

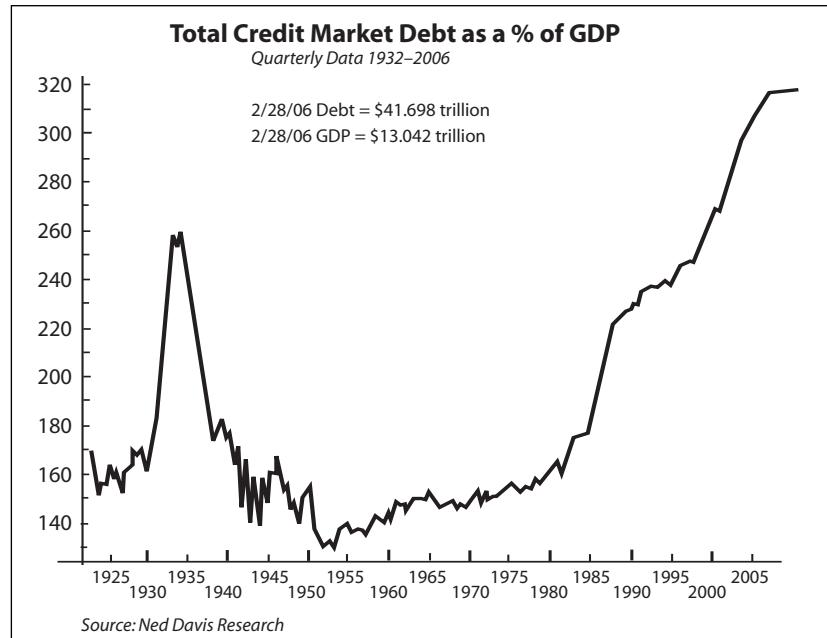
Is this a reasonable calculation? Our categorical answer is no. Few people seem to be aware of the tremendous leverage inherent to this calculation of wealth creation. It arises from the collective practice to value all existing assets automatically at the prices of the last marginal trade. In the United States, only about 5% of all existing houses are traded every year. Actual capital gains on these trades are minimal.

But these small actual capital gains grow into recorded trillions in wealth creation through the conventional practice of transmitting the average increase in the prices of the small lot of actually traded houses to the huge existing stock of houses. This results on paper in 20- or 30-fold wealth creation. The Federal Reserve even gives explicit publicity to this “wealth creation” in its Flow of Funds Accounts.

We have always rigorously disputed that it makes sense to regard this as wealth creation. Even the owners of the houses gain, in reality, nothing from the rise in prices. Everyone may feel richer. But they are no richer in housing comfort or anything else. If anyone will later change his residence to a place of the same quality, he has to pay the same high price for which he sold.

In reality, the homeowner gains one thing only, and that is higher collateral for higher borrowing. Reckless utilization of correspondingly higher borrowing facilities is the central feature of every bubble economy, leading to exponential debt growth. So it happened in the late 1920s in the United States, and in the late 1980s in Japan, and so it has happened again in the United States during the last few years.

It is a strange fact that the monetarists in their arguments about the causes of the U.S. crisis in the 1930s and Japan’s crisis since the early 1990s completely ignore the disastrous wealth destruction that occurred owing to the



later clash between accumulated record-high debts and collapsing asset values. Their apparent view is that whatever the cause of the economic downturn, everything would be all right if only monetary policy eased fast and sufficiently.

## **THERE INVARIABLY COMES PAYBACK TIME**

Assessing the U.S. economy's prospects, the most important thing first to take into account is that what has happened is not the garden-variety business cycle. It is a grossly overindebted and unbalanced bubble economy, in which borrowing and indebtedness, particularly for private households, have gone to unprecedented extremes in chasing house price inflation. Also, we have to start with the recognition that once asset prices stop rising, the game is up.

But the buying stampede is bound to be followed by a selling stampede when asset prices stop rising, and even fall, and this now with the same tremendous leverage on overall asset values to the downside as had earlier worked to the upside.

The potential of the post-bubble crash in asset prices largely depends on the size of the prior excesses. The other day, professor Robert J. Shiller of Yale University declared that the present housing boom in the United States "*is the biggest on record.*" The only time since record-keeping began in 1890 that compares to the recent residential real estate market is just after World War II, he said (as reported by MarketWatch's Amy Hoak):

*"After the war, the soldiers came back and they wanted houses and started the baby boom. And when you had babies, you wanted houses with at least two bedrooms — and that was not so common back then. They went on a buying spree, and it pushed home prices up," he said.*

*The recent boom, however, doesn't have the same fundamental variables causing prices to soar, he said, adding that variation in such things as building costs, population and interest rates doesn't adequately explain the reason for the housing boom.*

Our comment: The one and only thing that explains the U.S. housing bubble of the past several years is protracted, extraordinary monetary looseness provided by the Greenspan Fed, and that, of course, makes it particularly vulnerable.

To emphasize our key point about bubble economies: A bubble economy needs rising asset prices to keep it going. Once the prices of those assets, which have lubricated the decisive assets — stocks and housing in the U.S. case — stall, let alone fall, the whole process stops and reverses with a vengeance, because former ample liquidity and wealth creation go into reverse.

With this in mind, let us take a closer look at the finances of private households, being the dominant deficit spender in the U.S. economy, vastly exceeding that of the government. In 2005, the public sector borrowed \$479.5 billion, against \$1,208.7 billion borrowed by private households.

With real disposable incomes of private households now in stagnation, any increase in consumer spending essentially depends on borrowing — mainly against rising house prices.

Current spending on goods and services increased by \$559.6 billion, an amount far below the level of total new borrowing. Another \$102 billion went into purchases of residential buildings. Both items add up to \$661.6 billion, representing the deficit spending of the consumer. Private households thus ended with a surplus of close to \$550 billion from their borrowing, allowing them to acquire financial assets.

This has, in actual fact, been going on since the late 1990s. Remarkably, most of that borrowed money has gone into bank deposits, which since 2000 have increased by \$1,901.5 billion, to \$6,251.4 billion. So households are very liquid? Taking the simultaneous rise in total asset values into account, the ratio of bank deposits to total asset values has slightly improved, from 8.9% in 2000 to 9.5% recently.

***Where are the big problems in this scenario? They are in two factors: first, in the potential declines of***

*the asset prices, and second, in the stagnation of real disposable incomes of private households. The two are going to bear the brunt of future debt service and asset sales.*

## **PONZI FINANCE**

Principally, private households can increase their spending in two ways. The normal, traditional and only sustainable way is through income growth. For decades after World War II, American households used to spend less than their incomes, putting part aside as savings.

The second possibility, heavily practiced during recent years, is to borrow against rising prices of existing assets. But over time, debts have to be serviced and repaid from future income. Hyman Minsky distinguished between three different types of financing of positions in assets: hedge, speculative and Ponzi finance:

- 1) Hedge financing units and their bankers expect the cash flow from operating capital assets to be more than sufficient to meet contractual payment commitment units now and in the future. Consequently, such a unit cannot have much debt.
- 2) Speculative financing units and their bankers expect the cash flows from operating assets to be less than the cash payment commitments. Speculative financing involves the short financing of long positions.
- 3) For Ponzi financing units, interest payments exceed the debtors' current incomes. Banks capitalize unpaid interest as new credit.

Minsky fails to mention the worst case of all, today virulent in the United States. It is the case in which debtors borrow against rising asset values without any addition to cash flow from the asset. Assets only function as convenient collateral for higher borrowing, typical of a bubble economy.

Mr. Greenspan and the American consensus have made a virtue of this new kind of growth. But asset prices will never rise to the sky. In the past, sustained long-term economic growth would have required a transition from asset-driven growth to self-sustaining income-driven growth. The exact opposite has happened. With stalling income growth, the economy today depends more than ever on asset-driven growth.

## **ZERO INCOME GROWTH**

Badly lagging employment and income growth are the great shortcomings of the present U.S. economic recovery. A temporary gain in real disposable income during 2003–04 owed largely to the generous tax cuts of the time. But absent new tax cuts and against the backdrop of rising inflation rates, real disposable income growth has slumped to zero. In 2005, its growth rate was down to 1.3%, and in 2006, it is close to zero. This compares with a growth rate of 3.4% in 2004, 2.4% in 2003, 3.1% in 2002 and 1.9% in the recession year 2001. Before the economy's downturn, in 2000, the growth rate was 4.8%.

**This is the worst income performance in the whole postwar period. Yet it finds nil attention. There seems to prevail an assumption that households possess in their high net worths ample cushions to maintain their pace of spending in excess of current income growth for some time to come.**

## **NO CHANGE OF THE BATON**

What has to happen to increase U.S. household incomes? Forget about easier money. In order to turn easy money into production and income effects, a borrower is needed. With the consumer grossly overstretched, this borrower would have to be the business sector borrowing for capital investment.

It is one of the most striking macroeconomic developments of recent years that in major economies, the corporate sectors have been able to significantly increase their profits at the expense of their labor forces. Inflation-adjusted average wage rates in the United States today are just minimally higher than in 2000.

But contrary to past experience, corporations have generally seen no reason to boost their capital investment, which would have translated the higher profits into higher employment and income growth. As the American consumer is forced to retrench, a splurge in business fixed investment will be needed to avoid recession in the United States.

Over the five years from 2000 to Q1 2006, business fixed investment, in current dollars, has increased by merely 11.5%. Considerably lagging the cumulative inflation rate, it has been the weakest component in the U.S. recovery by far, comparing with simultaneous nominal GDP growth of 32.8%.

Profit reports in the past have shown a generally steep rise. That is from the recession low. From a longer perspective, their development is hardly exciting, except for an exceptionally steep jump in 2005. For us, the profit benchmark is the year 1997. In that year, profits of the nonfinancial sector peaked at \$508.4 billion. Seven years later, in 2004, they hit \$534.2 billion. But in 2005, this figure jumped to \$854.2 billion.

Not surprisingly, different sectors of the economy have performed very differently. The striking laggard is manufacturing. It earned \$209.0 billion in the peak year of 1997. In 2005, this was down to \$118.9 billion. Retail trade, in contrast, boosted its profits over the same period from \$64.2 billion in 1997 to \$90 billion in 2005. Comparing the profits of the two sectors in 1985 gives some idea of the drastic restructuring to which the U.S. economy has since then been exposed. In 1985, manufacturing earned \$84.3 billion, against \$22.2 billion in retail trade.

It is certainly reasonable to say that U.S. manufacturing is in a depression while retail trade has been enjoying a boom. The obvious cause is the exploding trade deficit diverting a large and growing part of domestic demand for goods to foreign producers. A further thing to see is that this shift between manufacturing and retail trade has far-reaching further economic implications. An important one is that manufacturing has a far higher employment and investment ratio.

Our earlier question was whether in the United States the business sector might take the baton from the consumer as the new driver of economic growth. For this to happen, it would be necessary that the sector invests in excess of its current cash flow. That was the case in 2000, with an amount equivalent to \$310.8 billion, or 3.1% of GDP. Last year, businesses were the one sector in the U.S. economy that ran a savings surplus. The normality, of course, is that businesses spend the savings of private households on capital investment.

Nevertheless, business borrowing in the past few years has been rising at a pretty fast clip. Only it does not go into capital domestic investment. Sharply higher spending has been going into dividends, stock buybacks, mergers and acquisitions. None of this, of course, adds to employment and GDP growth, but it is supposed to increase shareholder value.

Drawing the decisive conclusion: There is not the slightest chance for the U.S. economy to shift from consumption-led to investment-led economic growth. From this perspective, recession is the only possible alternative.

## **WHEN MONETARY POLICY FAILS**

But to repeat: This will not be a garden-variety recession, in which monetary easing unleashes pent-up demand, as it used to do in past business cycles. The consumer, on the contrary, has through his protracted borrowing binge heavily borrowed from the future. At the same time, there is nothing in the business data to suggest an impending investment recovery. Slumping consumer spending, rather, can only tend to stifle it still more.

During the 1930s in the United States and since the early 1990s in Japan, monetary easing has proved ineffective in restoring economic growth. For American monetarists, this can only have one single reason: the failure of the central bank to ease sufficiently.

Actually, we see a third striking case of ineffective monetary policy, and that is Germany's very poor economic growth since the late 1990s. Despite historically very low interest rates, both businesses and consumers refuse to borrow and to increase their spending. The latter even refuse to lower their high rate of saving, hovering persistently at a little over 10% of disposable income. There has been zero increase in domestic

bank credit for many years. Yet broad money growth is running at an annual rate above 8%.

We find the German case particularly instructive, because the underlying causes are perfectly obvious. Business propensity to invest has fallen in relation to the saving propensity of private households, leaving a gap in domestic demand. For monetarists, believing in the omnipotence of monetary easing, this imbalance is easily solved by further rate cuts.

To us, there can be no question that the behavior of both sides in Germany has a variety of causes, among which interest rates may well be the least important. It would be quite reasonable to assume that private households, facing decreased income from their savings in consequence of lower interest rates, may even step it up. As to businesses, on the other hand, it cannot seriously be assumed that the long-term interest rates at their present record-low level are the main obstacle to an investment boom.

In actual fact, there has been a third major factor at work depressing German economic growth for several years now. That is a prolonged slump in residential and commercial building. In this sector, it is outright depression. What happened is that the big building bubble that developed in the wake of German unification has gone bust.

The boom lasted four years, until 1995, while the bust is now in its 10th year. At long last, this seems to be stabilizing. Over this period, building has fallen more than 20%, subtracting from GDP growth year for year. It goes without saying that this involved, in addition, huge capital losses for firms and banks, which unquestionably hampered their future activity.

We elucidate and emphasize this quite unspectacular German experience for two reasons. One reason is that we keep pondering the economic and financial aftermath of the present U.S. housing bubble; the other is the obsessive faith of American monetarists in the omnipotence of central banks to generate the desired rates of money growth and inflation under any circumstances, being supposedly critical for economic growth.

Intensive studies of the dismal U.S. experience in the 1920–30s and Japan's recent experience leave us with the distinct conclusion that the decisive spoiler in the case of bubble economies in reality is always the sequence of rampant asset boom and corresponding asset bust.

What makes those asset bubbles so dangerous is their association with equivalent debt bubbles. While later asset prices collapse, the record-high debts remain untouched. If the earlier lavish wealth creation has been all-important in driving the prior boom, one has to assume that the following massive wealth destruction through the collapsing asset prices is of similar importance in depressing the economy.

Consider also that the associated capital losses to a large extent hit with a double whammy, to wit, borrowers and lenders alike. Amazingly, American monetarists do not give a single thought to this dramatic sequence of massive wealth creation and destruction and implicit strong effects on the future activity of borrowers and lenders. This consideration alone makes it a compelling reason for central banks to be careful in allowing rampant asset price inflation.

## **THE RESPONSIBILITY OF CENTRAL BANKS**

Recently, at the Western Economic Association's panel discussion in San Francisco, somebody in the audience posed the question:

*Q: Professor Friedman, do you think there is a role for the Fed in identifying and managing asset price bubbles?*

*Milton Friedman: No.*

*Q: Could you elaborate?*

*Friedman: The role of the Fed is to preserve price stability. Period. And price stability in a broad aggregate — in a broad index. It should not be concerned with the asset markets as such, only as they affect indirectly — somehow — the price stability as a whole.*

Federal Reserve Bank of St. Louis President William Poole then spoke:

*Poole: If I could just add to that. I absolutely agree. And one of the reasons I take that position — I am really a hard-liner on this. Let us suppose that the Fed — as you would want with any good policy instrument — had perfect control over asset prices. I think it is incompatible with a market economy to have a government agency setting asset prices that are meant to allocate capital.*

To pretend that asset markets must be left to market forces is, of course, ridiculous. Changes in monetary policy are at all times a major influence. In the absence of domestic savings, the U.S. housing bubble has its source exclusively in the credit excess created by the Fed.

### **MR. GREENSPAN'S GREAT FAILURE**

We presume that utmost confidence in the capability of monetary policy to inhibit greater trouble for the economy and the financial system plays a great role in the thinking of American economists and investors. Is not that what Mr. Greenspan effectively demonstrated with his drastic monetary easing in 2001–03? Despite the bursting equity bubble, he achieved America's shallowest recession in the whole postwar period.

We would not take this experience as evidence of efficient monetary policy. We think it, rather, proves the opposite, that underlying demand conditions are crucial in determining its efficiency. If there is pent-up demand, as used to be normal after phases of tight money, monetary easing works miracles. But following a period of excessive consumer or investment spending, it can only fail.

It was Mr. Greenspan's great luck that when the equity bubble burst, a second bubble, the housing bubble, was just in the making. By blowing the bond bubble in addition, he dealt the housing bubble a big push. Rising house prices quickly repaired the damage wrought on household balance sheets by the bursting equity bubble, launching America's greatest consumer borrowing-and-spending binge, while business investment was slumping. But this is definitely not repeatable.

Looking only at the mild recession of 2001, it may seem a highly successful policy. But what followed were more than five years of an economic recovery comparing miserably, even abysmally, with all postwar recoveries by some most important measures like employment and income growth.

During the postwar years, it became customary to measure an economy's performance primarily by GDP and productivity growth, both being virtual proxies of employment and income growth. But this relationship in the United States has completely broken down. Since the recession's end in November 2001, reported productivity growth is up 14.7%, while inflation-adjusted wage rates remain flat.

### **EMPLOYMENT SPIN**

Reported employment growth in the United States during the current economic recovery is an outright disaster. In total, it is up 1.9% over five years from the end of the recession in November 2001. According to the Economic Policy Institute in Washington, this compares with average growth of 9.7% over this period in prior postwar recoveries.

There is strong reason to assume that even the small reported employment growth is largely a statistical hoax. That is because the Bureau of Labor Statistics (BLS) composes the reported employment numbers from two different sources. One is its monthly survey covering 160,000 firms and government agencies. The other is a pure estimate of job creation through new firms unknown to the BLS.

The origin of the latter goes back to the 1980s. At the time, the BLS noted that IRS tax information showed stronger employment growth than its surveys. In response, in 1985, it instituted a “plug factor,” or “bias factor,” adding about 35,000 jobs each month to the survey results, representing a rather limited addition.

In 2000, though, the BLS pulled a completely new paradigm out of its bag, a “net birth/death” adjustment,

reflecting the “actual residual of net births and deaths over the previous five years.” It differed in three ways from the old “plug factor.” *First*, it was to grow into much bigger numbers, while the survey results became weaker and weaker. A *second* novelty was pronounced variations from month to month. *Third*, the net birth/death specifies the sectors in which job creation through new firms has taken place.

All this intrinsically conveyed the impression that this new adjustment had its base in more precise calculations. The strange title derives from the fact that the BLS learns of business deaths within weeks, while it learns of business births only after many months. In the apparent assumption that dying businesses have their equivalent in newborn businesses, the BLS uses the former as an earlier indicator of the latter. In other words, the higher the death rate when the economy turns down, the higher the reported birth rate. Among the many absurdities in American statistics, this is definitely by far the worst.

This absurdity is plainly evident in the recent job numbers. Over the three months April–June, the BLS reported the creation of 329,000 nonfarm jobs. But this has come about with a stunning contribution of 657,000 from the net birth/death model, accounting thus for about 200% of the total job creation. Without this adjustment, reported employment would have slumped. Please note that these net birth/death jobs would, if annualized, add up to more than 2.6 million new jobs. It is a postwar record.

We are supposed to believe that during the past few years a limited number of new firms in the United States has created millions of jobs, while the huge army of existing firms is sacking labor.

<b>Jobs Created (2001-07-19-2006)</b>			
	<b>Survey</b>	<b>Net Birth/Death</b>	<b>Net*</b>
2001	-1,763,000	282,000	-2,045,000
2002	-535,000	390,000	-925,000
2003	112,000	574,000	-462,000
2004	2,067,000	827,000	1,240,000
2005	1,981,000	865,000	1,116,000
2006	854,000	715,000	139,000
Total	2,716,000	3,653,000	- 937,000

\*Net: without addition from net birth/death model  
Source: Bureau of Labor Statistics

Since new jobs mostly arise from smaller businesses, it is more helpful to look for a break in the pattern as a source for small business planning. The National Federation of Independent Business (NFIB) is an organization of 600,000 small business owners. It publishes a monthly report, *Small Business Economic Trends*, surveying its membership. The figures for May and June 2006 show a turn in the exact opposite direction of the net birth/death projections. The NFIB Optimism Index, Outlook for Expansion and Sale Expectations have fallen off a cliff in May and June.

By the way, the above figures are all from the BLS. Yet you would look for them in vain in the monthly Employment Situation report. It does not mention the existence of the whole model. The figures are published on a separate “net birth/death” page, to which there is no reference in the text of the main report.

## **FROM BUSINESS CYCLE...**

We keep reading more and more reports warning of “overkill” by the Fed in case it continues its rate hikes. It is an argument that greatly irritates us, because it apparently assumes that a cessation of further rate hikes, or even cuts, could and would prevent the recession. We strongly believe in the postulate of the Austrian School that the conditions driving the economy into recession accumulate during the boom years. This also brings us straight to the question of what makes monetary easing ineffective.

**Monetary policy impacts an economy mainly through its interest-sensitive areas, of which there are three: *first*, commercial and residential building; *second*, business fixed investment; and *third*, consumer durables.**

The two dramatic examples of complete inefficiency of monetary policy are, of course, the U.S. Great Depression and Japan’s protracted economic malaise since the bursting of two huge bubbles, in equity and commercial real estate. The easy explanation, which the American monetarists put forward, is that the two central banks simply acted too hesitantly.

That is an easy judgment with knowledge of the following disaster. Compared with past regular experience, both central banks had acted pretty fast. Meanwhile, for over six years, Japan's central bank has practiced zero interest rates, combined with rising liquidity injections, which have virtually drowned the banking system in excess liquidity. For many years, the economic effect has been zero.

We have an entirely different explanation. It is true that monetary easing has, in general, always worked perfectly. But that was within the framework of the normal business cycles, which have been ruling most of the time. Recessions generally had their causes in monetary tightening by the central bank, elicited by rising inflation rates. The tighter money curbed the spending in the three interest-sensitive areas: consumer durables, business fixed investment and residential and commercial building.

Once the central banks eased, the suppressed demand components promptly shot up. This has been the pattern of the business cycle in all industrialized countries. What manifestly made monetary easing so effective was the fact that earlier monetary tightening had created a lot of pent-up demand. Easing removed an existing restraint. Therefore, it had prompt, strong effects.

### **...TO BUBBLE ECONOMY**

This pattern is, obviously, radically different from that of a bubble economy. Here, the long rise in asset prices, widely conceived of as wealth creation, leads people or firms to step up their spending, with heavy resort to credit out of proportion to the underlying growth trend.

This is, of course, the precise opposite of what happens in the typical business cycle recession. It creates pent-up demand, while the bubble economy preceding the recession has created excess demand. Extraordinary asset bubbles produce extraordinary credit and debt bubbles, which produce extraordinary spending bubbles. This is the dangerous essence of a bubble economy.

Everybody enjoys the unprecedented wealth creation. But two inherent effects, unfortunately, spell the great trouble for the future. One is that the credit bubble has its other side in exponential debt growth; the other is that the spending excesses in relation to current income are bound to reverse later. In the case of firms, the bubble-related overinvestment makes for excess capacity and malinvestments; and in the case of the consumer, the bubble-related spending excess simply borrows from the future.

Yet there always comes into play a second major malign cause, severely aggravating the bubble-related recession. It results from the fact that plunging asset prices have their counterpart in rigid, elevated debt levels, pulling holes into the asset side of balance sheets.

An American monetarist is sure to tell us that the fall in asset prices will not take place when the central bank eases fast enough. Whether or not asset prices are going to crash will primarily depend on the future relationship between debt service growth and simultaneous increases in current disposable income.

In the United States, the household debt-service burden is at a record high, and rising, owing to a combination of upward adjustments of interest rates and soaring new borrowing.

On the other hand, it has to be taken into account that this is happening against the backdrop of stagnant real disposable income for private households.

It is under these circumstances a compelling conclusion that the rising debt service has increasingly been met by Ponzi finance, meaning that the lenders capitalize unpaid interest by adding the amount to the outstanding credit. This must be playing a large and growing role. It keeps the credit expansion in full speed, but with less and less of it finding its way into the economy. That inflation-adjusted retail sales are negative while debt is growing at double-digit rates makes frightening reading.

Evidently, Ponzi finance has its limits. There comes the point when the lenders demand cash payment for the debt service. To make these payments, the debtors may choose between curbing their spending and selling assets. One weakens the economy, and the other weakens asset prices. In the end, both cumulate. This is the

critical point in the development of the bubble economy and the markets.

*To summarize: The decisive problems of a bursting bubble economy are always of three kinds: first, the collapse of grossly inflated asset prices hitting balance sheets; second, accumulated horrendous debts; and third, the prior spending excesses forestall future spending. The combined result is a mixture of conditions that diminish the effectiveness of monetary policy. Depending on the size of these imbalances, they may completely defeat monetary policy.*

When the U.S. economy in 1930 began to slide into depression, it had behind it a prolonged burst in stock prices and a succession of spending booms in virtually all economic demand components: business investment, residential and commercial building and consumption. When the Federal Reserve eased in 1929–30, none of these components responded. Why? Was there a credit crunch? Or were there other reasons causing businesses to curb their spending?

In the view of the monetarists, the decisive restraint arose from the circumstance that the Federal Reserve had strangled bank lending and economic growth with overly tight money. This implies that businesses and consumers wanted to borrow.

There was definitely no money tightness for businesses. As Joseph Schumpeter describes in his *Business Cycles*, after businesses had taken full advantage of the prior period of loose and cheap money, they entered “*the Great Depression with a financial outfit which was nothing short of luxurious.*”

The stunning fact, completely overlooked by the monetarists, is that during the 1920s, the securities markets, not the banks, were the business sector’s one and only source of finance. During 1927–29, net securities issues of the business sector amounted to \$18,000 million. Bank lending and investments increased by \$4,527 million over the same period, virtually one-quarter of the securities issues.

What is more, nothing of the banks’ lending went to businesses. Fully half of their credit expansion financed soaring stock purchases on margin — “security loans” — particularly since 1924. This does not include the huge flow of brokers’ loans for the same purpose. “All other loans” of banks, including commercial loans, were no higher in 1929 than in 1921.

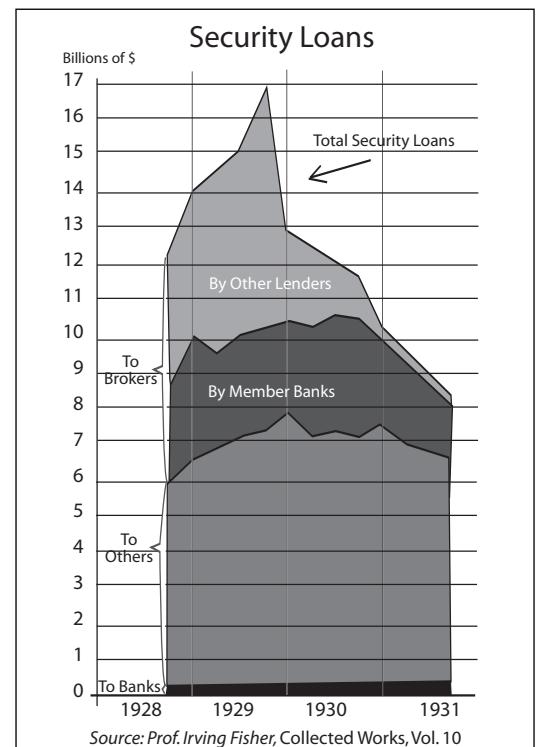
Clearly, this had made for a precariously balanced financial system. Monetary ease worked through the securities markets. While banking activity had become heavily dependent on financing and fueling rising asset prices through its investments and security loans, the securities markets had, in turn, become heavily dependent on this support from the banks.

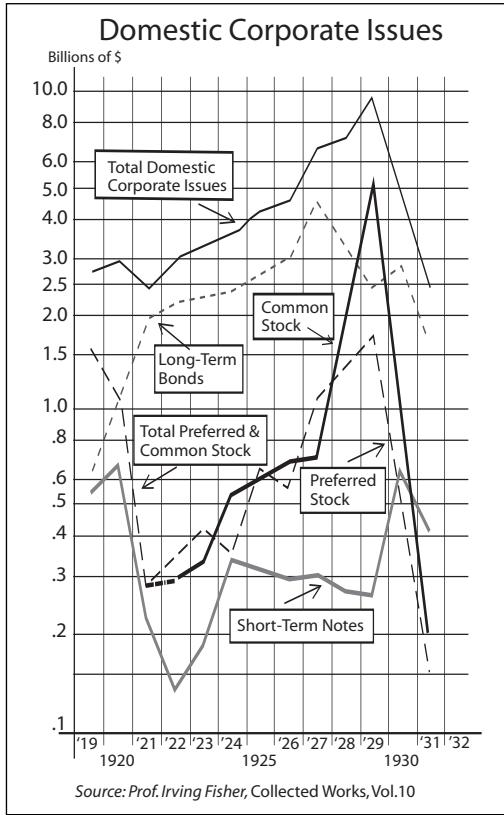
What actually began to reduce the money supply in 1930–31 was not a decline in commercial lending. It was a sudden sharp contraction in the banking system’s security loans, for which the crash of the stock market is certainly the most reasonable explanation.

Far more dramatic changes, however, took place in the securities markets. The abrupt prior boom in bond and stock issues just as abruptly collapsed. From 1929–1931, gross corporate issues plummeted from \$9,376 million to \$2,371 million.

The obvious all-important question here is what all of a sudden stopped the securities issues? Was it tightness in the markets? But then long-term interest rates ought to have soared, which they did not. Or was it other events that induced corporations and consumers to curb their spending, despite monetary easing?

We presume the long boom of the 1920s, repeatedly whipped up by bouts of monetary easing, was coming to a natural end. The easing of 1927 had operated to drive up stock prices and consumption, while





investment and construction slackened.

From this perspective, the crash of the stock market appears to have been the cataclysmic event, which in conjunction with unprecedented record debt levels incurred during the boom years precipitated calamitous liquidations. One of the results was the total ineffectiveness of monetary policy that monetarists consider impossible.

## BUBBLE ESSENCE

We have taken this glance back into the U.S. experience of the early 1930s with the question in mind of what will happen when the present U.S. asset and credit bubble peters out or bursts.

One of the most amazing things about American monetarists is that they never mention the words “credit” and “debt.” From empirical research, they have learned that there existed in the past a strict correlation between money supply growth and economic growth. To them, that is enough to make apodictic assumptions about their correlation, regardless of obviously most drastic differences in underlying economic and financial conditions between past and present.

In our view, “bubble economies” develop unique features that forbid any comparison with economies moving within the normal business cycle.

It seems a compelling *a priori* conclusion that the elements that decisively drove the boom are equally decisive in generating the painful aftereffects when asset and credit bubbles reverse.

In Japan’s case, the bubble excesses were manifestly centered in business fixed investment and commercial building. In the last bubble year, 1989, businesses spent, on the back of soaring stock prices and cheap credit, an amount equivalent to 9.1% of GDP in excess of their very high cash flow on industrial investment and commercial real estate.

What happened when the bubbles burst? Average commercial real estate prices fell 185% and stock prices 70%. The amount of wealth lost as a result of these price collapses is equivalent to 2.7 years of GDP growth in the year of peak asset prices — that is, 1989. For the United States, this would today translate into about \$35 trillion.

There can be no question that the decisive calamity when an asset bubble bursts is the inherent huge wealth destruction through collapsing asset prices against unyielding debt levels. Japanese corporations for years have been battling the huge wall of debts left over from the bubble years. They are bent on repaying them, even though they cost almost nothing. What induces and forces them to do this up until today are their weak balance sheets. Monetary policy becomes ineffective.

## WEIGHING THE PRESENT

How does the present situation in the United States look from this perspective? A rule of the Austrian School says that the pain of recessions is about commensurate to the extent of excesses in the prior boom. Looking at the horrendous U.S. trade deficit, negative savings from current income, record-high debts and stagnation in real disposable personal income, the U.S. economy is today definitely in far worse shape than in 1929, and also in 2000.

The credit expansion continues to run amok, but more and more of it is due to escalating Ponzi finance, leaving less and less for spending in the economy. Think that inflation-adjusted retail sales, including a large share of foreign goods, are lately negative, and just 1.4% above their year-ago level.

The borrowing-and-spending binge of the past few years was centered in residential building and consumer durable goods. Both components soared — up 38.5% and 36.6% — out of proportion to GDP growth of 16.1% between 2000–Q1 2006. It has to be assumed that the spending binges in these two components will be followed

by a temporary spending dearth before returning to the trend in line with GDP growth.

Among the negative factors, we regard one as particularly ominous. That's the stagflation in the real disposable income of private households arising from unusually weak employment growth and a stunning increase in the CPI by 4.2% year over year.

This decline of real disposable consumer incomes into stagnation has to be seen against the fact that consumer debts since 2000 have ballooned by 70%, and that they continue to balloon. With this vast difference between income growth and debt growth, it is one of the worst debt traps in history. For sure, lenders will increasingly demand debt service in cash. That is the critical inflection point.

To get out of this trap without painful cuts in spending, the first preferred step for many is certainly to sell owned assets — stocks, housing, etc. Private households turn into aggressive net sellers of assets. But buyers will be rare and reluctant. As a result, the selling will have its main impact in lowering prices at limited turnover. Former massive wealth creation turns into massive wealth destruction. As earlier explained, changes in asset prices work with huge leverage on balance sheets, down as well as up.

There is a widespread view that ample existing liquidity together with new liquidity injections by the Fed will prevent greater economic and financial damage. The first thing to realize is that the U.S. liquidity deluge of the last few years has had one single source: borrowing against rising assets backed by the Fed's monetary looseness.

It is all borrowed liquidity, its existence hinging on further rises in asset prices. But they are going to plunge. One of the things to be learned from the U.S. experience in 1929–30 and Japan's experience 60 years later is that this kind of liquidity has the bad habit of disappearing overnight when asset bubbles burst.

## **CONCLUSIONS:**

It is by now a moot question whether the U.S. economy will slow down. It is happening, and at a pretty fast clip. Most important aggregates — employment, retail sales and housing starts — are generating solid recession warnings. Firing people is apparently the first response by businesses. Over the past three months, private sector job gains were 44% below the average monthly gains in 2005. Recall it was a labor-intensive bubble.

Most people, apparently, expect a brief, mild economic downturn, followed by a quick economic rebound. First of all, the high inflation rates are sure to put considerable restraint on the Fed's easing.

But what are the demand components that will probably respond to the new easing? After so many years of prior spending excess and, moreover, asset prices in a sharp fall, the consumer is sure to retrench. Nor is there, for sure, pent-up demand in residential building. There is talk of pent-up demand in business fixed investment. We see mostly companies, which appear to have a strong preference for mergers, acquisitions and stock buybacks, boosting shareholder value. In short, the U.S. economy's rebound after a brief "pause" is an illusion.

There will be a rude awakening.

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